



THE EVALUATION OF SAUDI INSURANCE INDUSTRY AND POTENTIAL FOR TAKAFUL INSURANCE



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ABSTRACT

One of the study's aims is to define the legal conflict between the law of Supervision of Cooperative Insurance Companies and Saudi Arabia's regulations of implementation and to outline the principal obstacles in this conflict. Subsequently, the results of implementation regulations on the aforementioned companies' performance and the perception of their potential *Shari'ah* compliance will undergo critical examination. Detailed interviews with Saudi *takaful* operators are used for data collection with the goal of detecting and investigating the problems in the Saudi insurance *takaful* models and practices. Once this is done, suitable improvements that are needed to ensure *Shari'ah* compliance and consistency can be suggested. The second piece of Saudi *takaful* insurance research, in the form of a questionnaire, will attempt to appraise *takaful* models in use, in line with International Association of Insurance Supervisors (IAIS) criteria. As the number of *takaful* operating companies in the targeted market is relatively large, the study aimed at covering the most popular *takaful* companies in Saudi Arabia. In order to gather a valuable information concerning Saudi insurance market, we contacted the supervising authorities and requested them to provide three participants who will participate in this study. In total, three companies were selected for the interview and also were covered to fill the questionnaire.

1. Introduction

Saudi Arabia, which follows a traditional form of Islamic law, has opted for regulation of its hitherto unregulated insurance market. The *Shari'ah* compliance of the *Al-Tawuniya* (cooperative insurance) model which has been adopted by Saudi insurance is still a contentious issue. This study intends to outline in case studies, the performance of Saudi Arabia's three principal *takaful* companies: the National Company for Cooperative Insurance NCCI (*Tawuniya*), Company for Cooperative Insurance, *Amana takaful* company and *Arabia takaful* company. Qualitative and quantitative methods will be applied and therefore it is certain that the companies and clients themselves will be able to profit from any recommendations made and results obtained.

One of the study's aims is to define the legal conflict between the law of Supervision of Cooperative Insurance Companies and Saudi Arabia's regulations of implementation and to outline the principal obstacles in this conflict. Subsequently, the results of implementation regulations on the aforementioned companies' performance and the perception of their potential *Shari'ah* compliance will undergo critical examination.

Detailed interviews with Saudi *takaful* operators are used for data collection with the goal of detecting and investigating the problems in the Saudi insurance *takaful* models and practices. Once this is done, suitable improvements that are needed to ensure *Shari'ah* compliance and consistency can be suggested. The second piece of Saudi *takaful* insurance research, in the form of a questionnaire, will attempt to appraise *takaful* models in use, in line with International Association of Insurance Supervisors (IAIS) criteria.

2. Literature Review

2.1 The National Company for Cooperative Insurance

The National Company for Cooperative Insurance (NCCI) is a Saudi joint-stock company, it was incorporated in 1986 to provide *Shari'ah* compliant solutions to the customers across Saudi Arabi. It has been a pioneer company in KSA in promoting *takaful* and *retakaful* service to the general public. For 28 years, it has committed to its values and principles by providing Shariah compliant solutions to its customers. NCCI offers a wide range of *takaful* products in family *takaful*, general *takaful* and health *takaful* to individual and corporate customers. It is deemed to be the largest company in the world of Saudi which have obtained a classification 'A' from Standards and Boards (S&B). The company started with a capital of 500 million riyals, the recent capital is amounts to SR

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2.2 Arabia Takaful Company

Arabia is a Saudi joint-stock company; it was incorporated in 1979 to provide Islamic financial service to cater the need of a large Muslim community. Its licensing was approved by Royal Decree No. M/6, dated 31/07/203. The capital of the company is two hundred million Saudi Riyals (200.000.000) the company's objective is to be one of the leading companies in the provision of insurance services to cooperative public service customers seeking insurance products that are compliant with Islamic Sharī'ah. In 200, the company restructured its units and expanded its operations to the selected markets outside of Saudi where takaful products were in high demand by potential customers due to its unique fair system.

2.3 Amana Takaful Company

Amana takaful company, a subsidiary of Bank Islam Saudi, was the first takaful company to start takaful operations in Saudi in 1985 with an authorized capital of RS. 500 million and paid up capital RS 10 million. The company was converted into a public limited company in 1996 raising the capital to RS. 55 million. Currently, the company maintains paid-up capital of RS.152 million. The company offers a wide range of products in personal takaful, health care, and education. The company is following the Mudarabah takaful model that is based on profit sharing with participants.

3. Research Model and Hypotheses

The questionnaire in this study was confirmed only to the quantitative questions, and all qualitative questions were discussed under the interviews. For questionnaire, we benefit from the core principles (ICPs) that have been issued by the International Association of Insurance Supervisors (IAIS), which provide prudential standards and the basis for effective regulation insurance companies across the world. The questionnaire aims to measure the applicability of the ICPs standards to the *takaful* insurance and to assess whether or not the *Sharī'ah* restricts any of these standards or principles which might be only applicable to conventional insurance. The questionnaire comprises four parts. One is related to corporate governance standards, reporting standards, fraud detection and the last part deal with *Sharī'ah* compliance standards. All the questions given in the questionnaire were the same for all the insurance companies.

The interview was comprised of ten questions representing several themes which need to be addressed in this study; these are as follows, reasons for choosing operational models for *takaful* companies, capitalization and distribution, risk management and finally general views concerning the obstacles and future of *takaful* in the country of Saudi Arabia. Undoubtedly, the interview provided the author with an opportunity to discuss the gathered information with the respondents and to inquire and justify any certain trend in the data that needed to be justified. All the three companies were interviewed at either Chief Executive Officer level. All the interviewed companies were ¹from Saudi Arabia, and it should be noted that the interviewed companies were the same companies that completed the questionnaire as well.

4. Methodology

An internal validity measure was established by interviewing after gathering the quantitative data in order to match the findings between the two methods. This helped to understand the nature of the company, some facts about its business, and the structure of its regulation and rendered an opportunity to question any response that was given by the interviewee. Therefore, the figures challenged their position whereby they were given the right feedback to encourage them to answer in a proper manner. With regards to the reliability, all of the interviews were recorded, and the results were reported and analysed later. The data obtained from the questionnaire was analysed by utilizing Excel 2003. However, all the interviews were recorded and for each company, the responses were written in individual worksheets and then the author did a comparison between all the answers given under each question was asked.

5. Data Analysis and Results

A. What is the current takaful operational that is most popular in your view? Wakalah, Mudarabah, or Hybrid?

The first interviewee indicates that in Saudi most *takaful* operators are making use of the hybrid *Wakalah* type of *takaful*. The second interviewee states that after some consideration of the *takaful* models used globally, his company has resolved to use the *Wakalah* model. The last interviewee states that the *Mudarabah* model was the chosen model used for managing *takaful* in his company's case.

B. What are the reasons for the management, Board of directors (BOD) and the Shariah Committee for choosing to adopt this model?

The first interviewee reports that the *Mudarabah* and *Wakalah* models are the two models in use for Saudi *takaful* products. The *Mudarabah* model is considered somewhat controversial by the majority of *Sharī'ah* scholars as they contend, it refutes the original nature of the *Mudarabah* contract, and it is therefore not widely used in the administration of *takaful* Products. This is the principle reason that the Hybrid *Wakalah* or Modified *Wakalah* model is preferred by the Board of Directors, Management and *Sharī'ah* Committee of the TOs. The point of contention in the use of *Mudarabah* model is that the fund administration costs are taken from the *Mudarabah* capital (i.e. the *takaful* contributions of the insured). The fact that the costs may be higher than the profit, could lead to a situation where the costs have to be recovered from the *Mudarabah* itself, thus rendering the entire process worthless, so *Wakalah* model contains lesser *gharar* as compared to the *Mudarabah* model because the portion of expenses is charged under the upfront *Wakalah* fee.

The *Mudarabah* contract also implies that the entrepreneur has the responsibility to share any created profit with the supplier of the original capital. A profit deemed profit if the entrepreneur manages to generate more the provided capital. Basically, a *Mudarabah* investment of 100 can only be thought of as profitable if the resulting profit figure is higher than 100. In *takaful*, the situation is different as the surplus shared is net of claims, reserves, *retakaful* and costs. The interviewee contends that any surplus being divided among the participants and TOs should not be understood as profit, as this surplus is unrelated to the definition of profit maintained in the principle of *Mudarabah*.

Another cause of Islamic scholars' aversion to the *Mudarabah* model for managing the *takaful* funds is the question of *Qard Hassan* (Free loan). In the event of a shortfall in the *takaful* Fund, the *takaful* operator is required to provide *Qard Hassan* loans to fund contributors. The interviewee is strongly of the opinion that this practice runs contrary to the principle of *Mudarabah* in which any surplus or shortfall is shared. The interviewee concurred that the *Wakalah* model is less contentious, hence it being acknowledged by Islamic scholars in both Saudi and the Middle East who prefer its free nature. Bank Saudi, has not expressed any hostility to its use. The lengthy nature of the administration of the Family *takaful* product is another motivation for the Saudi preference for the modified *Wakalah* model. As with the early years of any enterprise the expected revenue can be minimal; therefore the increased benefits to the TOs make the modified *Wakalah* more fitting for the management of Family *takaful* products. The fact that *Wakalah* payments are made to the TOs upfront give a greater likelihood of survival of the Family *takaful* product.

Meanwhile, on the second interviewee, the senior manager justified and explained the reasons behind their selection of *Wakalah* model, the interviewee states that within his company's *takaful* model, all participants give the company permission and absolute legal authority to act on their behalf as an agent to run the *takaful* package according to the *Wakalah* model. The interviewee continued by saying that one of the strongest reasons for choosing *Wakalah* model is that the *takaful* operators receive income from four different sources; (i) any surplus in the *Wakalah* underwriting fee, (ii) any profit created from the management of *takaful* fund assets, (iii) profits from the TOs own capital investments, and (iv) a potential share of the return on investments, as a fee to encourage high quality performance. These principles are the main motivation for the choice of the *Wakalah* model.

In the same manner, by looking to the third interview, the respondent stressed that there is no particular *takaful* model can be said to be the best for both the *takaful* operator and the *takaful* participants. According to his view, each model has advantages and disadvantages and each aims to achieve slightly different aims. He indicated that it is difficult to judge the degree of qualities of each of these models which all serve their purpose in a definite way. For example, in our model which is *Mudarabah* practices are considered better for investment aspects of *takaful* fund, while *Wakalah* is preferred for its risk-sharing features in *takaful* operations.

The interviewee continued by saying that the *Mudarabah* model allows the operator to partake of any operating surplus as a bonus for administering the underwriting process for the contributors to the fund. Thus there is an incentive to undertake the underwriting process effectively and administer claims prudently. In addition, the *takaful* fund never belongs to the operator of the fund, but to the contributors. In the situation of a loss occurring, the contributors may suffer a financial loss, whereas the TO suffers only a wasted exertion and effort.

The interlocutor says that by the contrast the *Wakalah* model distinguishes between the *takaful* fund and the *takaful* operator (*Wakeel*), the later charges a fee deducted from contributions made by participants and investment profits; this management fee is related to the level of performance, and since the *takaful* operator does not share in the underwriting result, the *Wakalah* model requires that it negotiates all expenses on behalf of participants to provide the lowest possible cost. All operational costs should be clearly reported to policyholders to guarantee the transparency of all operations and reduce elements of conflict of interest between parties of the *Wakalah* agreement. However, it is still not confirmed that when this model would be commercially viable when it is fully implemented.

C. Based on the company's current practice, is the surplus of the underwriting in the PSA shared between participants and shareholders? If it is shared, is it stated in the contract (Aqad)? And if so, please state the ratio?

The first interviewee identified that any excess in the guaranteeing of the Participant's Special Account (PSA) is fairly divided amongst all participants and shareholders. This process is clearly delineated in the contract. *Takaful* Operators (TOs) hold that the percentages rest on the product chosen (family *takaful* is available in a number of options). Yet the interviewee added that due to participants rarely reading the contracts through and an absence of knowledge of the products, the majority of participants are ignorant of the conditions. Profits resulting from the investment of the participant's account are divided amongst the all contributors and shareholders. The interviewee prefers this method as he sees that profit is deserved for the work done during the investment for the participant. However, the interviewee contend that this practice is somewhat unwarranted as TOs have already benefitted from the cost of the *Wakalah* and any surplus resulting from the underwriting.

Just in the same way, the second interviewee states that within the rules of the *Wakalah* model, all moneys contributed to the fund should initially be placed within an individual investment account (IIA). The fund in this account will be invested by operator, the participants agree at the whole, when the account is started, to certain amounts of money being periodically transferred to a second *Taawuni* Account (TTA). The contributions are invested by the fund operator. According to the *takaful Wakalah* model, any surplus is jointly owned by the policyholders and may be reduced by a performance fee incentive for the operator before distribution to the policyholders. The rate of any *Wakalah* fee is fixed every year in advance, after discussion with the company's *Shari'ah* committee. This *Wakalah* fee, which is expected to cover expenses incurred by the operators, is collected from contributions made, and is expected to encourage high quality maintenance of the fund, in that the fee is connected to the performance of the policy.

In like manner, the third interviewee distinguishes between surplus and profit. He states that profit occurs when the administration costs of the fund are lower than investment revenues. This profit may be divided according to a predetermined method in the *Mudarabah* model, or at a certain pre-established percentage. In Contrast, surplus refers to the excess of premiums over claims, plus investments return. Surplus sharing refers to act of distributing the excess made during the past accounting period among the participants of the risk fund or pool.

D. Based on the company's current practice, who is liable for any losses arising from the investments of the Family Takaful Fund?

The first interviewee defined the three possibilities if the Family *takaful* fund should fall short:

- i. Contributors may add funds to make up the shortfall.
- ii. TOs may make up the shortfall through a benevolent loan.
- iii. In the situation where the shortfall in the *takaful* fund is a long term situation, the TOs may transfer the fund. In this situation, however, it is noted that contributors rarely want to introduce more funds. Interviewees state that this situation is results in only one viable option – that of arranging for a benevolent loan to make up any shortfall.

Similarly, the second interviewee responds to the issue of liability of loss by saying that, by entering into this contract (*Wakalah* model) the participant appoints the company as *Wakeel* for the management of the *takaful* fund and as *Mudarib* for the purpose of investing the participant's contribution in a *Shari'ah* compliant manner. All participants are considered equally liable for any losses suffered. The participant would be recompensed for any damage or losses incurred, according to the contract's terms, conditions and exceptions. These losses or damage shall be recompensed from the *takaful* fund. All participants shall donate the whole or a part of their *takaful* fund donations into a co-operative *takaful* fund for the benefit of all participants. The calculation of any surplus is carried out on an annual basis. In the event there is surplus, the company in its sole discretion shall distribute such surplus to the eligible participants. And vice versa the third interviewee states that in situations where a shortfall occurs, it is covered using an interest free loan which will be reimbursed from future contributions by the members of the fund.

E. Do you find any loopholes of the current model that you are using to manage your Family Takaful fund?

With respect to the first interviewee, the interviewee expresses the opinion that in some areas the *Wakalah* model is unfair to the contributors as the model may amass large profits. To outline, TOs accumulate income in the following manner:

- i. The initial *Wakalah* fee (up to a maximum of 40%).
- ii. X% of profit amassed from investment of the Contributor's account.
- iii. X% of the excess from the underwriting.

The interviewee's suggestions to address the issue stated above are extensive. There is agreement that one concrete solution to those issues does not exist. One possible method to counter the large profits is for *Shari'ah* advisors to recommend a maximum limit on *Wakalah* fees that may be levied on the contributors.

Identically, the second interviewee, the issue of underwriting surplus sharing has at times been subject to disapproval. The interviewee continues that there is disagreement among *Shari'ah* scholars as to whether participants should be allowed to share in the surplus of the amount *takaful* contribution which they have already donated to a *tabar'ru* fund. Equally, *takaful* operators have no right to share the surplus amount as they have already received *Wakalah* fee or their share of profit. Now the question arises if neither participants nor *takaful* operator has legal right on the underwriting surplus, where this amount should go, a number of *Shari'ah* scholars believe that this surplus should be placed into a *Waqf* fund for charitable purpose and should be used for the welfare of poor and needy people of the society, even though they are not part of the *takaful* Company. Another group of scholars believe that underwriting surplus could be returned to the participants as a gift or *Hibah*. Markedly, the third interviewee stressed that the issue of surplus distribution is considered to be a great disadvantage of this model. The interviewee mentions that jurists have reached two views on the *takaful* industry in both the Middle East and Saudi. The first view fundamentally prohibits the sharing of underwriting surplus between the *takaful* operator and the participants. The second view permits the sharing, based on ratios that differ according the line of products offered. To rephrase this, *Shari'ah* scholars are dissatisfied with the division of the underwriting surplus that can be seen in the *Mudarabah* model, as *Mudarabah* can be understood as an equity contract in which losses must be borne by the provider of the capital alone, while profits may be divided proportionately. The crux of the matter is that the remaining principle capital, both under profitable or losing conditions must be return back to the capital provider.

The interviewee also says that the definition of surplus, under *Mudaraba* contract, surplus, should be profit, and not the principal, thus, the operator is entitled for the profit but not the remaining principal. What is happening in the market right now is that, the surplus is anything left after the total risk fund is deducted with claims, and it includes the balance principal. The responder says that let us assume that the operator is using *Mudarabah* model, if the *takaful* operator use the *Mudaraba* model, it only entitle for the profit and not the principal amount. In addition, it must return the principal amount back to the participant, a process which not happens yet in the market, what is happening now is that, both the *takaful* operator and participant share the profit (if any) and the principal amount.

F. What factors affect your premium pricing decision?

The first interviewee notes that market conditions have a great influence on the pricing of premiums. He says policies must remain competitive not only in pricing but also in the features accessible to customers, and the same time has to provide the policyholders with the same features offered by other insurance providers. In like fashion, the second interviewee states that decisions on the pricing of premiums are largely affected by both the company's financial stability and their creditworthiness. This ability to withstand risk, or the potential need to divide risk with other firms, has a large influence on the pricing of *takaful* premiums. In this, it can be seen that both *takaful* insurance companies and conventional insurance companies face similar factors in reaching decisions on policy premiums. Equally important, the third interviewee, the pricing of premiums is in some way affected by the environment of the firm's operating market. Transaction prices fluctuate according to the region and thus, the prices of premiums do also. The costs of compliance also have a part to play in the decision making process of pricing premiums.

G. How do you distribute your product?

The first interviewee alleged that information on products is disseminated by both direct marketing and brokers. Distribution and marketing costs are kept low by the implementation of a mass marketing strategy. Regarding brokers, clients are accessed through companies such as financial institutions and mortgage companies. Concerning the second interviewee, Mr speaker states that the dissemination of international *takaful* products is undertaken in the same manner as for a conventional insurance company, such as marketing directly to the public and the use of agents and brokers. This is not forbidden by *Shari'ah*. The last interviewee indicated that the distribution of the company's product is the same as the conventional one, by using brokers and agent.

H. Who is responsible for risk management in the company?

Notably, the interviewee states that a risk management structure is often part of a company's structure. The risk management committee has a designated person who understands the market and business and proposes action plans. Another important part of the risk management structure is the staff of underwriters whose role it is to mitigate losses to the business. Turning to the second interviewee, the interviewee states that the company's pricing issues and other aspects of risk management are undertaken by an engineer. The last interviewee stresses that the same underwriting and risk assessment procedures are undertaken as in the conventional insurance companies and that one distinguishing feature is in the type of risks, as no *haram* (prohibited) business can be undertaken. The most obvious variation is the different business model, which is based on a truly mutual model, *al-Idaratu bi al-Mal al-Mutlak*, rather than premiums. The pool belongs to the contributors and the *takaful* company merely acts on the pool rather than premiums. Published by International Journal of Business Society.

contributors' behalf in order to realise a profit for the contributors. Shareholders receive rewards through *Wakalah*, which can be seen as an initial fee. It is evident that any augmentation in the profit of the pool will result in augmented return to the shareholders.

I. In your opinion, what is the major obstacles and challenges facing by takaful?

The first interviewee outlines the three main issues facing *takaful* operators: a paucity of customer understanding, which has led to a lower level of market penetration than could have been achieved. He says many consumers are still unaware of *takaful* as an alternative, and some *takaful* as commercialisation of conventional insurance into the Islamic world and refute that it can be *Shari'ah* compliant. The majority of information on *takaful* is directed at industry users and investors, rather than being targeted at consumers. The second issue is the clear lack of Islamic scholars with a fitting understanding and experience of *takaful*. Each company is required to contain a *Shari'ah* supervisory board, made up of at least three *Shari'ah* scholars. Those TOs wishing to expand into a larger area should aim to build a greater level of credibility with the target group or market, leading to a partiality for board members to come from the target markets, or as a minimum requirement, to have an understanding and awareness of the target market. Scholars would ideally have experience and knowledge not only in Islamic jurisdictions but also in *takaful*. This is essential as board members are responsible for certifying the *Shari'ah* compliancy of business operations. However, the member of *Shari'ah* scholars with experience in both Islamic jurisdiction and insurance is limited; inevitably, these scholars are currently sitting on multiple boards, which may create conflicts of interest and compromise the quality of advice. The shortage in scholars remains a short-term barrier on new entrants and drives up the cost of setting up a sharia board. Whilst this may only be a temporary issue, it results in a rise in the cost of establishing a *Shari'ah* board.

The interviewee's third point of contention is that due to both the relative newness of the industry and variety of *Shari'ah* interpretation, the industry is in need of standardisation. A large number of issues, such as which definitions and practices can be declared *Shari'ah* compliant, for example, which *takaful* model should be adopted and which sources of capital are appropriate.

Moving on to the second interviewee, the interviewee pronounces *takaful* insurance as, an aspect of retail insurance designed for the Muslim faith. He continues that a number of issues face the *takaful* industry, despite its great recognition among different communities around the country. Primarily among these is the absence of a scientific system of ranking risks, an issue not present in conventional insurance, which has customary rates for fire, motor insurance and life insurance, prepared by actuaries. This is not offered in the *takaful* system. Another issue is the problem of reinsurance using the *takaful* model, and a general shortage of *takaful* companies. As Mr speaker states, "currently the challenge is to have a large enough *takaful* market to justify *retakaful* business". Referring to other potential issues facing the industry, the interviewee also makes reference to the number of defaulting *takaful* participants and the shortage of appropriate tools to manage risk and eliminate fraud. He also states that "also the high rate of default by beneficiaries of *takaful* and lack of efficient risk management tools to eliminate fraud and other risks are among the challenges," the interviewee also mentions a lack of information on market credit and other hazards.

Regarding to the last interviewee, the interviewee stress that, in his opinion, *Shari'ah* issues is still a problematic issue need to be resolved: he stressed that *Shari'ah* scholars who provide *Shari'ah* supervisory services to *takaful* operators belong to different schools of thoughts (*Hanafi*, *Shafi*, *Humbali*, *Maliki*) propagate different opinion on *Shari'ah* matters according to their belief in particular school of thought. Identify issues of independence, confidentiality, competence, consistency and disclosure of responsibilities that affect functioning of SSB in the organization. Due to lack of competent *Shari'ah* scholars in the field of Islamic insurance, most of the scholars hold positions in *Shari'ah* Supervisory Boards (SSBs) of several companies. This may jeopardize the confidentiality of the company secret information and company may restrict SSB to access certain information and hence affect its independence in the organization. SSB decisions on *Shari'ah* matters might not be consistent as the company might not properly disclose the responsibilities of SSB and restrict their authority in certain areas. Mr speaker states that the SSB should guarantee only *takaful* funds that are fully compliant with the requirements of *Shari'ah*. Clearly investment in manufacturing of *alcohol* would be impermissible. However, a situation might arise where while the *takaful* fund is managed in accordance with *Shari'ah* law, some of the income may come from a source that would be considered prohibited under *Shari'ah*. For instance, a company might finance a commercial air company or hotel, both of which are allowed under *Shari'ah* law. However, if it were discovered that some of the capital for this airline or hotel came from the sale of *Alcohol* or from financing of debt, then the investment would not be permissible.

Lastly, the interviewee admits that adoption of a *takaful* model raises issues of corporate governance regarding the rights of participants who are the provider of funds for the *takaful* company. Although *takaful* operators work on behalf of the participants, act as administrators of the funds and receive, through *Mudarabah* or *Wakalah* fee, a part of the fund's profits, yet they have been criticized for maximizing the shareholders' profits while ignoring the rights of the participants. This lack of corporate governance policy means that companies and their board of directors are not seen as accountable for choices made that are

unfavourable to participants or society in general. Furthermore, participants do not take seats on the board of directors and therefore have no ability to reject any decision made by the board, which results in a feeling of insecurity. There is a clear need for the regulatory structure to be improved to monitor the activities of TOs and as a result to safeguard the rights of the contributors to the funds.

J. In your point of view, what do you believe in the future of takaful?

The first interview predicts that there is potential for a 20 % rise in *takaful* premiums over the next 15 years, resulting in a total of approximately \$7.4 billion. As he says the Muslim world has the lowest level of insurance penetration globally. This is due to the strong extended family system and interpretation. Another reason is a mistaken understanding of Islamic doctrine regarding financial protection. The prospective *takaful* market for Muslims in both Islamic and non-Islamic countries has not been realised to its full potential.

Concerning to the second interviewee, the interviewee reports that the future of the *takaful* industry is entirely dependent on industry players, which must take a more active role in educating their customers and regulators, while enhancing discipline in their activities, such as human resources, marketing and distribution processes and product development. By concentrating on such these factors mentioned, *takaful* players can ensure that the growth and profit potential of this industry is harnessed and that it experiences the same phenomenal growth patterns as the Islamic banking industry has through the last decade.

Turning to the third interviewee, the interviewee believes that *takaful* has made a large contribution to the worldwide insurance industry and has demonstrated its flexibility to enter markets. However, there is still the issue of a lack of understanding of *takaful* and more work is needed in this area as *takaful* is useful to everyone, regardless of faith, the interviewee sees the development of the industry to the two extremes of strictly *Shari'ah* focused services and products to those that merely pay lip service to the tenets of *Shari'ah* and lack originality or profit driven focus. These two poles are of course to be expected in the development of an industry, but 30 years in, it is to be expected that the *takaful* industry should now find a point of consensus. A careful balance is needed between the issues of firstly, following the tenets of *Shari'ah* which is vital for sustaining customer confidence, and secondly, bringing accounting standards into line. This can be achieved only through a harmonized dialogue between the *takaful* players, regulators, industry bodies such AAOIFI and IFSB.

6. General comments

On examination the first interview, it is evident that the *Wakalah takaful* model was company's preference due to its less controversial and clear cut nature. It is also widely accepted by both Saudi and Middle Eastern scholars for the same reason. However, in actuality, there is no *Shari'ah* restriction on the model used for forecasting. One point of note is that although the company is oriented towards *takaful* products, market conditions play a significant role in the pricing of premiums. The company is finding the diminutive size of its market troubling and has ambitions to expand into the wider region. Thus, one similarity exists between *takaful* and conventional insurance companies. It is the opinion of interviewee that by targeting products at the Muslim market alone, there cannot be enough growth. Therefore it would be wise to create and market its products in the same manner that it does conventional products, the sole variation being the ethical practices it uses and the assurance that the products are *Shari'ah* compliant. Distribution and pricing of *takaful* products are undertaken in the same manner as conventional products. The sole distinguishing feature between this *takaful* company and other *takaful* companies is that the profits are mainly invested rather than being shared among the shareholders. Generally speaking, this *takaful* company may be considered a *Shari'ah* compliant *takaful* company. Yet, with a need to remain competitive in the current market, it utilises some conventional processes.

Following this, it is clear on rereading the information gathered in second interview, that some important ideas on *takaful* industry have been shared. The preferred model and the reasons for this preference have been expressed and a comparison between *takaful* and conventional insurance industries made. The second interviewee expressed a preference for the *Wakalah* model and the diverse sources of income enabled by this model were the reasons given for this preference. It can be understood that a surplus resulting from the investment of a contributor's fund, net of management fees or any expenses occurring, is divided among the policyholders. The *Wakalah* fee charged by shareholders to meet business expenses is taken from the policyholders' contributions. The *Shari'ah* committee is consulted yearly in order to decide an annual rate for the fee.

Concerning the issue of loss liability, the contributors are seen as equally liable to reimburse any participant for any loss suffered. Concerning decisions relating to pricing policies, the second company is unlike a conventional insurance company. The factors considered are again alike e.g. the ability to bear risk, the participant is considered jointly liable with the remaining participants for compensating the loss suffered by any participant. As before, the method used to forecast is identical to that used by conventional insurance companies and *Shari'ah* compliant.

Product distribution is again undertaken in the same way as would a conventional insurance company, with the use of brokers and agents. As stated previously, an engineer undertakes the management of risk. This is unusual

the fundamental principles behind *takaful* insurance, of undertaking business ethically and in compliance with *Shari'ah* law.

With regard to the third interview, it is fair to say that the *Mudarabah* model is the most suitable model chosen by TOs. The interviewee admits that there is no one model in existence that could be considered the best for both TOs and contributors to *takaful* funds. Each model has its own qualities and serves its purpose. The *Mudaraba* model, that in use within the interviewee's company, is deemed more appropriate for the *takaful* fund's investment feature, whereas the *Wakalah* model is considered better for risk-sharing. It is the opinion of the interviewee that his *takaful* company is aiming to guarantee a consistent level of policy pool, as this is deemed highly important in *takaful* insurance. There is a noticeable rise in business in the Gulf region due to an increase in product awareness and backing from a number of Islamic institutions. The interviewee was very enlightening as to the main hindrances and challenges in the *takaful* field, particularly issues connected to the differences in the various schools of Islamic thought and how this diversity would affect *Shari'ah* decisions. He also raised the topic of the need for stronger corporate governance and a more systematic regulatory system to standardise both the rights of the *takaful* contributors and the activities of those administering the *takaful* funds. The interviewee stated similar opinions on pricing decisions to the other companies who were questioned. This company specifically targets those wishing to follow *Shari'ah* principles. Again, this company uses conventional insurance companies methods of product distribution; that is, direct distribution and by using brokers. The interviewee believes that the management of his company is similar to conventional insurance companies. The only variation is the group targeted by the company, and the manner in which the regulations of *Shari'ah* law affect profit sharing.

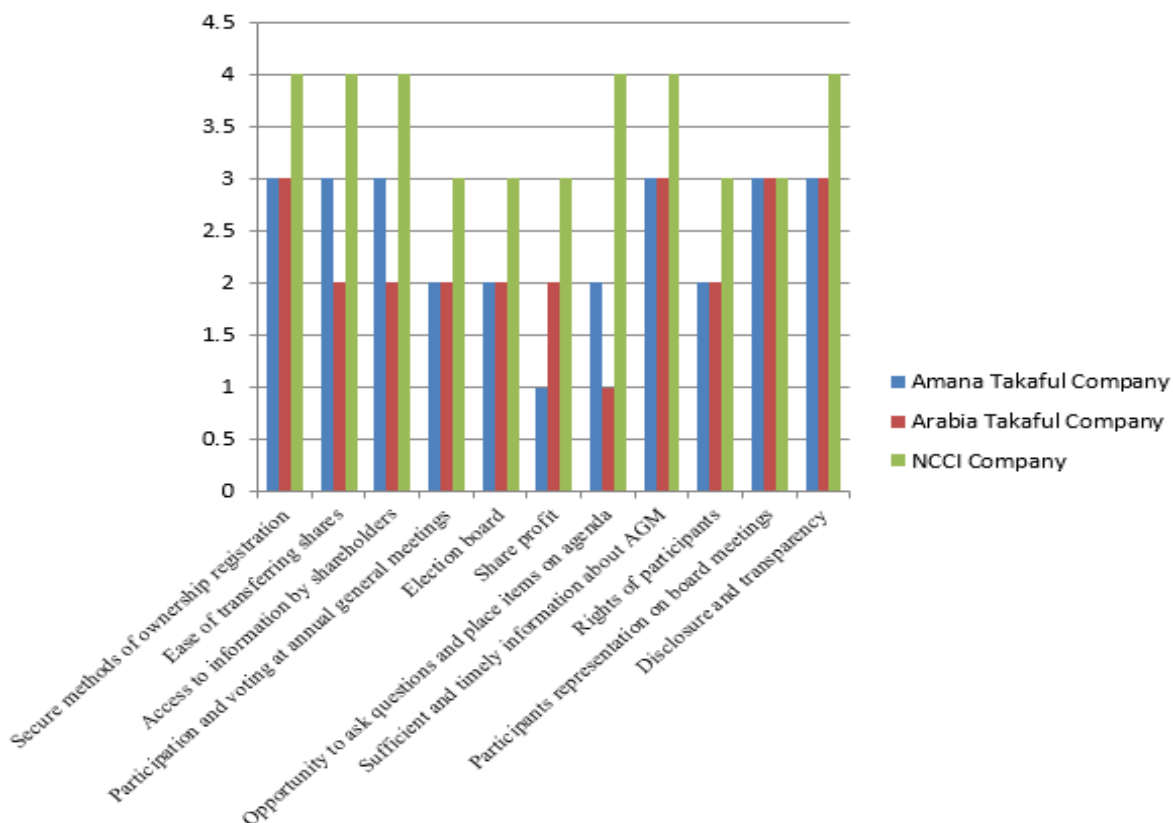


Figure 1: Corporate Governance Standards
(Coding of data: 1= Not observed, 2=Partly observed, 3= Largely observed, 4= Fully observed)

Figure 1 shows the eleven essential criteria required for compliance with corporate governance standards. Across the majority of the eleven given categories, all the three companies manage to demonstrate a partial observation of the corporate governance standards showing commitment to the criteria as a general concept. However, some variations exist. Within the category of 'Share profit', *Amana Takaful* records the lowest level– demonstrating that no compliance is observed. The same result is demonstrated by *Arabia Takaful* in the category of 'Opportunity to ask questions and place items on an agenda'. Again no compliance of this category is recorded.

It can be noted that both *Amana Takaful* and *Arabia Takaful* record the same results of partial observation of standards in three categories of participating and voting at AGMs, election boards and rights of participants. It may be that these three categories are considered less important than others or that the organisations have not yet

(NCCI) reports the highest levels of compliance of the three companies and is unsurpassed in every category. In six of the eleven categories it reports the level of full compliance and high observation of the standards in the other five.

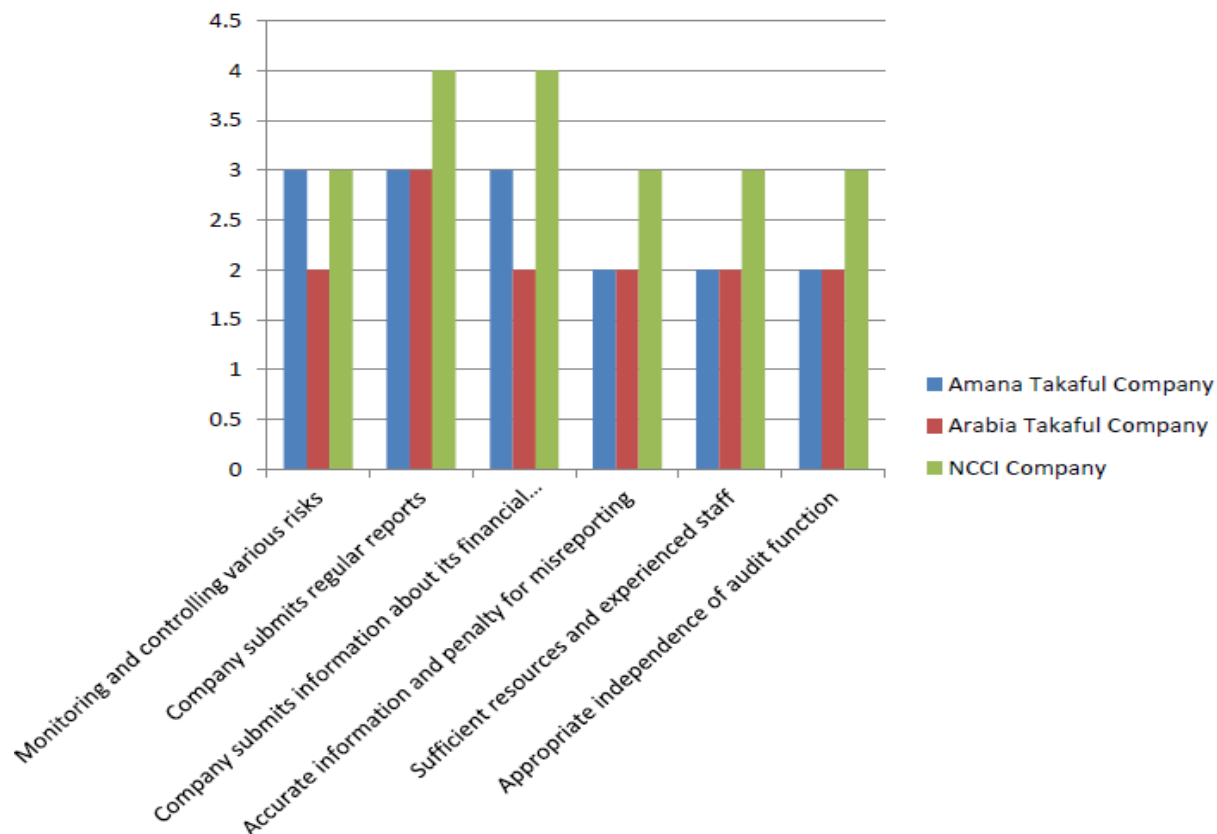


Figure 2: Reporting Standards
(Coding of data: 1= Not observed, 2=Partly observed, 3= Largely observed, 4= Fully observed)

Figure 2 shows the six essential criteria for reporting standards required of the three *takaful* companies. In all categories the National Company for Cooperative Insurance (NCCI) reports the highest or joint highest levels of observation. All three companies show that in five of the six categories standards are ‘partially met’, leaving room for an improvement of systems. In two categories, those of ‘Monitoring and controlling risks’ and ‘Company submits information about its financial performance’ *Arabia Takaful* demonstrates only partial compliance to reporting standards, while *Amana Takaful* reports that standards are largely observed. The highest level of overall compliance can be seen in the category relating to ‘company submits regular reports’, where both *Amana* and *Arabia* report that standards are largely met. Generally speaking, the National Company for Cooperative Insurance (NCCI) demonstrates the highest levels of observance of reporting standards.

Figure 3 shows the six essential criteria for the observation of Fraud Detection and Prevention Standards and the results reported by the three *takaful* companies: *Amana Takaful*, *Arabia Takaful* and the National Company for Cooperative Insurance (NCCI). While all three companies demonstrate that standards regulating the deterrence, detection and remedying of fraud are partially met, all other criteria are more closely met with two out of the three companies reporting that standards are largely met in each case. As has been seen elsewhere, the National Company for Cooperative Insurance (NCCI) consistently returns the highest or joint highest levels of compliance in all categories, demonstrating that all standards are fully observed in four of them. This might indicate that the National Company for Cooperative Insurance (NCCI) takes a more serious view of compliance with Fraud Detection and Prevention standards, or there may be stricter regulations in place within that particular country. Likewise, the lower levels of observance of fraud standards within the other two *takaful* companies could be seen as a representation of a less stringent attitude taken by the authorities towards total compliance.

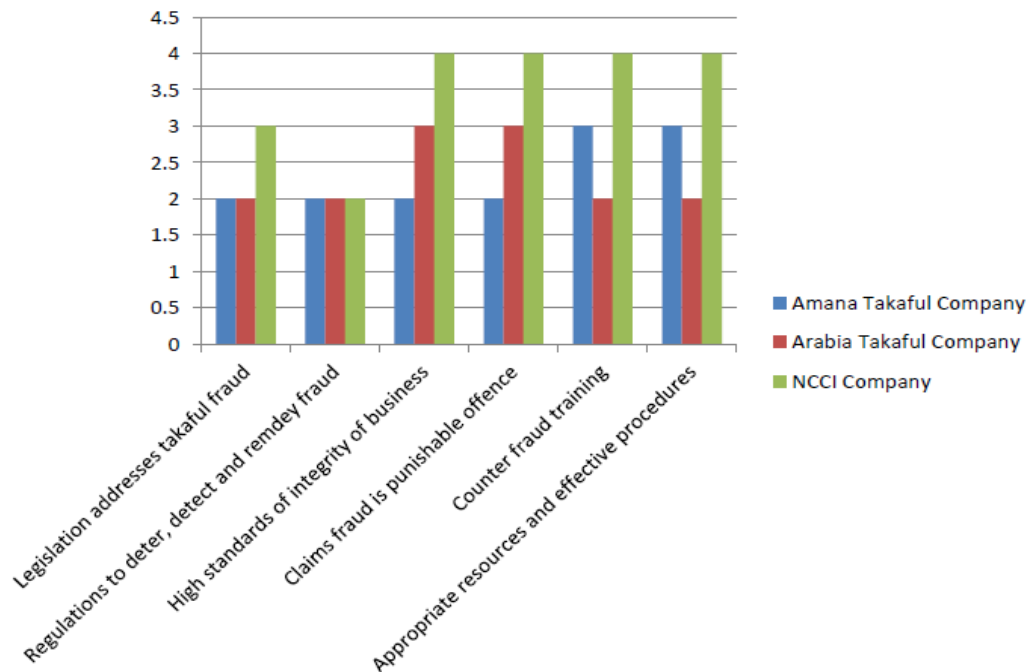


Figure 3: Fraud Detection and Prevention Standards
(Coding of data: 1= Not observed, 2=Partly observed, 3= Largely observed, 4= Fully observed)

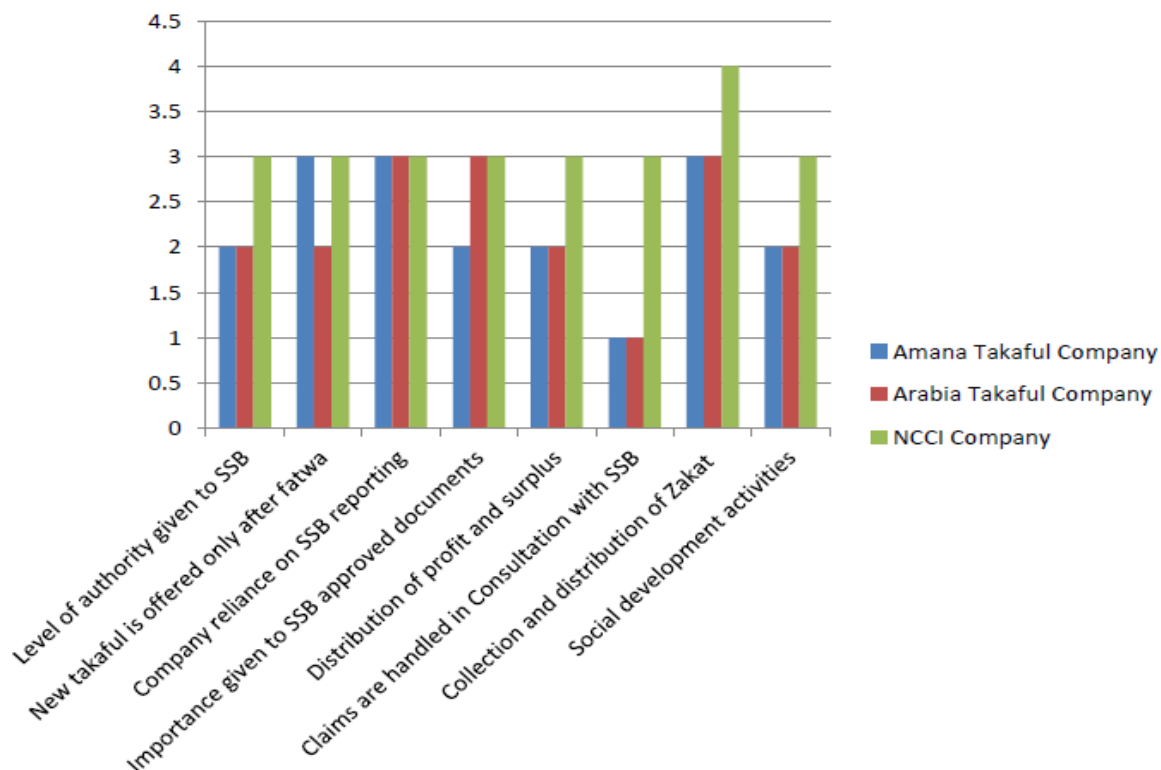


Figure 4: *Shari'ah* Compliance Standards
(Coding of data: 1= Not observed, 2=Partly observed, 3= Largely observed, 4= Fully observed)

Figure 4 illustrates the eight essential criteria for the observance of *Shariah* compliance standards. Overall, the National Company for Cooperative Insurance (NCCI) returns the highest levels of compliance, demonstrating that standards of *Shari'ah* compliance can generally speaking be said to be 'largely observed'. This is seen in seven of the eight required categories. In the remaining criterion, that of collection and distribution of *Zakah*, the

National Company for Cooperative Insurance (NCCI) shows itself to be fully in full compliance of the *Sharī'ah* standards. Regarding the other two companies, in six categories *Amana takaful* and *Arabia takaful* return very similar results, but in the remaining two, *Amana takaful* shows that standards are largely observed in the 'New takaful is offered only after *fatwa*' compared to *Arabia's* partial observation, and in the category of 'importance given to SSB approved documents' *Amana* shows only partial observation, while *Arabia* demonstrates standards are largely observed.

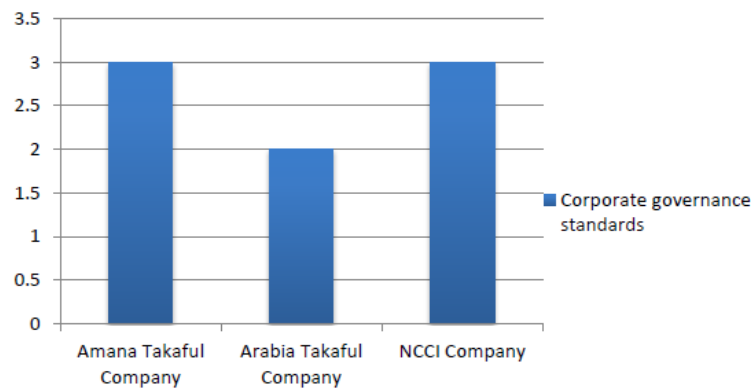


Figure 5: Corporate Governance Standards
(Coding of data: 1= Not observed, 2=Partly observed, 3= Largely observed, 4= Fully observed)

Figure 5 shows the level of observance of corporate governance standards witnessed among the three *takaful* Companies: *Amana Takaful* Company, *Arabia Takaful* Company and the National Company for Cooperative Insurance (NCCI). Levels of observance are rated from 1 'not observed' to a maximum level of 4, which implies 'total observance' of standards of corporate governance. The figure illustrates that of the three *takaful* companies, the *Arabia Takaful* Company demonstrates the lowest levels of corporate governance, its rating merely stating that corporate governance standards were partly observed within its practices. The other two *takaful* companies however, displayed identical higher results in this category. Both the *Amana Takaful* Company and the National Company for Cooperative Insurance (NCCI) showed evidence of corporate governance standards being largely observed in their working practices. This could be taken to indicate that both the *Amana Takaful* Company and the National Company for Cooperative Insurance (NCCI) take a more serious view of compliance with corporate governance standards, or there may be stricter regulations in place within their respective institution. Likewise, the partial observance of corporate governance standards within the *Arabia Takaful* Company could be seen as a representation of a less stringent attitude taken by the authorities towards total compliance.

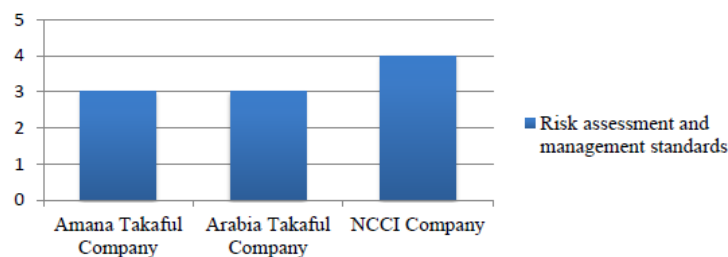


Figure 6: Risk Assessment
(Coding of data: 1= Not observed, 2=Partly observed, 3= Largely observed, 4= Fully observed)

Figure 6 shows the level of observance of risk assessment and management standards demonstrated by the three *takaful* Companies: *Amana Takaful* Company, *Arabia Takaful* Company and the National Company for Cooperative Insurance (NCCI). Levels of risk assessment and management are rated from 1 'not observed' to a maximum level of 4, which implies standards of risk assessment and management are fully observed. It can be seen that all three companies demonstrate encouraging levels of risk assessment and management in their practices with each of the three being able to boast that the majority of risk assessment and management standards are met. In greater detail, figure 6. shows identical results for the *Amana Takaful* Company and the National Company for Cooperative Insurance (NCCI), with both companies reporting that required risk assessment and management standards are largely observed. However, the National Company for Cooperative Insurance (NCCI) reports the most impressive standards of risk assessment and management, as they report that all standards in this category

are fully observed. This may be interpreted as the company taking the issue more seriously, or having more efficient systems in place, or the difference may be due to the fact that the company is of a longer standing than either *Amana Takaful* or *Arabia Takaful*.

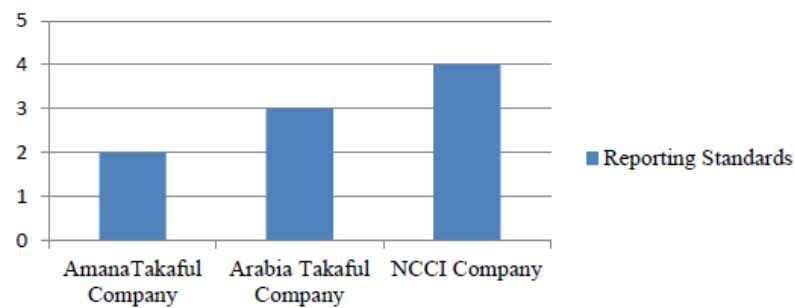


Figure 7: Reporting Standards

(Coding of data: 1= Not observed, 2=Partly observed, 3= Largely observed, 4= Fully observed)

Figure 7 shows the level of observance of reporting standards demonstrated by the three *takaful* Companies: *Amana Takaful* Company, *Arabia Takaful* Company and the National Company for Cooperative Insurance (NCCI). Levels of reporting standards met are rated from 1 'not observed' to a maximum level of 4, which implies standards of reporting are fully observed. The figure above illustrates that of the three companies listed; the *Amana Takaful* Company has the lowest reporting standards, which are stated as being merely partly observed in comparison with what may be required. The *Arabia Takaful* company demonstrates higher levels of observance of reporting standards, which are judged to be largely observed. Of the three companies, the National Company for Cooperative Insurance (NCCI) is unique in being able to state that all reporting standards required are fully observed by the company.

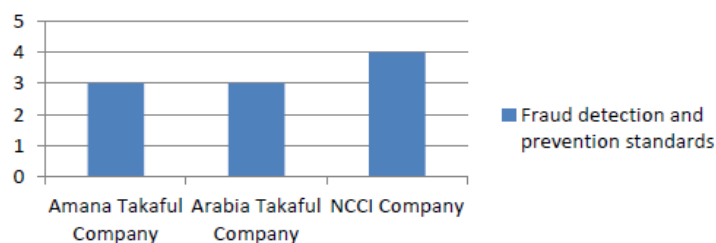


Figure 8: Fraud Detection and Prevention Standards

(Coding of data: 1= Not observed, 2=Partly observed, 3= Largely observed, 4= Fully observed)

Figure 8 shows the level of fraud detection and prevention standards demonstrated by the three *takaful* companies: *Amana Takaful* Company, *Arabia Takaful* Company and the National Company for Cooperative Insurance (NCCI). Levels of fraud detection and prevention standards that have been met are rated from 1 'not observed' to a maximum level of 4, which implies standards of fraud detection and prevention have been fully observed. The figure above illustrates that of the three companies listed, the *Amana Takaful* Company and the *Arabia Takaful* company both display the same level of compliance with fraud detection and prevention standards, with both companies demonstrating that these standards are largely observed. Of the three companies, the National Company for Cooperative Insurance (NCCI) is unique in being able to state that all fraud detection and prevention standards required are fully observed by the company.

Figure 9 shows the level of *Shariah* compliance standards demonstrated by the three *takaful* companies: *Amana Takaful* Company, *Arabia Takaful* Company and the National Company for Cooperative Insurance (NCCI). Levels of *Shari'ah* compliance that have been met are rated from 1 'not observed' to a maximum level of 4, which implies standards of *Shari'ah* compliance have been fully observed. The figure above illustrates that of the three companies listed, the *Amana Takaful* company and the *Arabia Takaful* company both display the same level of compliance with *Shariah* standards, with both companies demonstrating that these standards are partly observed. Of the three companies, the National Company for Cooperative Insurance (NCCI) gains the highest level of *Shari'ah* compliance standards, gaining a level of that shows that *Shari'ah* compliance standards are largely observed. None of the companies can claim that all *Shari'ah* compliance standards are fully met.

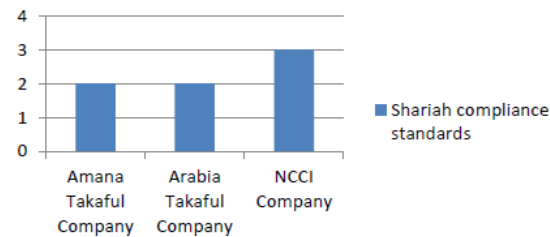


Figure 9: Shariah Compliance Standards
(Coding of data: 1= Not observed, 2=Partly observed, 3= Largely observed, 4= Fully observed)

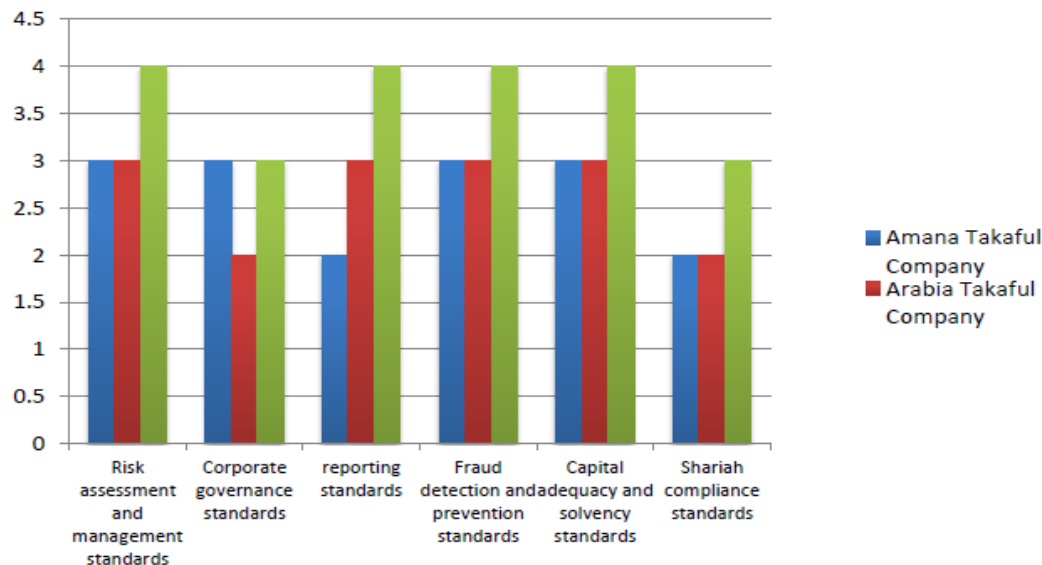


Figure 10: Takaful Standards Observed
(Coding of data: 1= Not observed, 2=Partly observed, 3= Largely observed, 4= Fully observed)

Figure 10 shows overall results of the six essential criteria for the observation of *takaful* standards and the reported results from the three *takaful* companies of *Amana Takaful*, *Arabia Takaful* and the National Company for Cooperative Insurance (NCCI). All three companies return a minimum level of partial observation of all the essential criteria. The Risk assessment and management criterion was largely observed by both *Amana Takaful* and *Arabia Takaful*, while the National Company for Cooperative Insurance (NCCI) showed full observance. This pattern was repeated in both the fraud detection and prevention and the capital adequacy and solvency criteria. With regard to corporate governance standards: *Amana* and the National Company for Cooperative Insurance (NCCI) showed large observation of expected standards, while *Arabia* was only able to demonstrate partial compliance. Reporting standards revealed the greatest variation, with only the National Company for Cooperative Insurance (NCCI) showing full observation. *Shari'ah* compliance standards have the lowest levels of compliance overall with only the National Company for Cooperative Insurance (NCCI) showing large amounts of compliance. None of the companies were able to claim full observance of required standards. Overall, it can be stated that the National Company for Cooperative Insurance (NCCI) consistently demonstrated the highest levels of compliance to the required standards. The reasons behind this result may, as have been previously stated be due to one or a number of factors. The company may be better established than the others or the premise of *takaful* insurance may also be more firmly established within Saudi. The issues may be regarded more seriously in Saudi than in other countries or *takaful* insurance companies may be subject to more stringent legislation. Finally, the National Company for Cooperative Insurance (NCCI) may have better systems of administration in place than the other companies.

7. Conclusion

The application of qualitative methodology in this chapter was done with the aim of appraising the effect of the Supervision of Cooperative Insurance Companies law and the associated principles. The manner that this has an influence on the National Company of Cooperative Insurance NCCI, *Amana Takaful* company, and also *Arabia*

Takaful company will be investigated in addition to attempting to resolve the question; Do the applications of *takaful* companies in Saudi Arabia meet *Shari'ah* law requirements?

In the examination of the various approaches and models, a study has been made of all the models in use by these companies. These are the *Mudarabah* Model, *Wakalah* with fee Model and the hyper model Agency-*Mudarabah* mode. During the investigation it was noted that both the *Mudarabah* and the *Wakalah* models may be classed as *Muawadah* (contracts of exchange). Hence, no differentiation between conventional insurance and mutual insurance can be made as both the models plainly embrace the essentials of exchange (*Muawadah*); therefore policyholders may achieve compensation from the fund, however it is impossible to eliminate every doubt over the potential acceptance of compensation. Only policyholders are able to apply to the fund for this reason. The *Wakalah* with *Waqf* model is the single model which may be considered compliant with Islamic *Shari'ah* law. However, no Saudi insurance companies use this model. It must be noted that a 10% management fee accompanies this model, which is taken from gross premiums (the *Waqf* assets and profits). This fee therefore results in the model becoming impermissible under *Shari'ah* law due to the fact that the agent's fee (*Nazer Al-Waqf*, as set in *Fiqhi* schools) must be taken only from the surplus. It may not be taken from the *Waqf* Fund, save the participant being aware beforehand of the management fee being removed from the premium. In this situation, the donor's intention is altered and therefore may be seen as *Shari'ah* compliant, as the payment has been divided in two; the first part for *Waqf* and the second part goes towards the management fee. The significance of this paper's analysis into Saudi Insurance laws and regulations is that as the Saudi constitution follows the principles of Islamic *Shari'ah* law, it is evident that all laws and rules must be *Shari'ah* compliant. All statutes and rulings that infringe *Shari'ah* principles are therefore considered void and therefore to be, theoretically inadmissible. Thus, the question under discussion must be: To what extent does the legal framework of insurance in Saudi Arabia comply with *Shari'ah* law? Responding to this question was challenging and the Saudi insurance system was evaluated from the standpoint of *Shari'ah* Law from a variety of perspectives and in due course, the research revealed the following:

1. Both Saudi and conventional insurance companies hold a comparable notion of insurance from the position of the rationality of its application
2. It is possible to view the connection between the company and insured (people) / total amount insured (fund) as no more than an agency with associated management insurance regulation charges which would then be classified as *deceit* (*Gharar*).
3. The manner of the surplus' distribution is dissimilar to that required by Islamic insurance and yet is commonly found in use in several Saudi insurance companies. Policyholders are denied rights by the shareholders' application of an inadmissible notion – that a proportion of the surplus (outside that income which has been earned by the company) should go to the insurance company.
4. The permissibility of co-operative insurance in Islamic theory does not necessarily mean the validity of the applications of the insurance companies. Even the establishment of an Islamic *Shari'ah* committee for insurance companies does not assure the legitimacy of neither the contracts written nor shareholders' treatment nor financial transactions. Thus, it is the opinion of the author that an independent central *Shariah* board should be established and endowed with all requisite authorisation for overseeing and reworking all regulations criticised in this work and in addition by other researchers and Islamic scholars.
5. Similarities in ideas to conventional insurance exist, in as much as the theoretical goal of insurance, its constructs and the nature of its practice are concerned. Overarching this, of course is the requirement for regulations to be *Shari'ah* compliant.
6. The current philosophy of the *Shari'ah* Board implemented in insurance companies suggests that there is no disapproval of contemporary commercial insurance companies, the insurance systems in operation nor the policies enacted. This permission may be tacitly seen in their consent of companies' contracts and activities.
7. It is worth noting that NCCI insurance policies can be said to be generally *Shari'ah* compliant. However a more commercial (rather than co-operative) style of policy is seen from both *Amana* and *Arabia* resulting in them being judged non *Shariah* compliant. In theory, any transactions with them are void, based upon the requirements of Article 1 of the law on Supervision of Cooperative Insurance Companies: 'Insurance in the Kingdom shall be undertaken through registered insurance companies operating in a cooperative manner as it is provided within the article establishment of the National Company for Cooperative Insurance promulgated by Royal Decree M/5 dated 17/5/1405 H, and in accordance with the principles of Islamic *Shari'ah*'. It is clearly necessary then to call for a redrafting of current insurance rules and regulations, to occur before any rewriting of currently invalid insurance policies. This strongly suggests that this study's hypotheses are based in fact.
8. An extremely interesting point of note is that *takaful* operators in Saudi were discovered to have the lowest *Shari'ah* compliance levels. A greater degree of disparity in fraud exposure, risk assessment, and capital competence standards were exposed among Saudi *takaful* operators. The *Arabia Takaful* company was discovered to be 20% non-adherence level to basic *takaful* standards than either *Amana Takaful* or NCCI.

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Research Questionnaire

A. Operational Models for Takaful companies

1. What is the current takaful operational model that your company is practising? i.e. Wakalah, Mudarabah or Hybrid.
2. What are the reasons for the Management, Board of Directors (BOD) and the Shariah Committee of your company for choosing to adopt this model?
3. Which one of the following is the best takaful model in your opinion? Wakalah, Mudarabah, Wakalah Mudarabah (Hybrid model), Wakalah Mudarabah Waqf (Hybrid model)
4. Based on the company's current practice, is the surplus of the underwriting in the PSA shared between participants and shareholders? If it is shared, is it stated in the contract (Aqad)? And if so, please state the ratio?
5. Based on the company's current practice, who is liable for any losses arising from the investments of the takaful fund?
6. Based on the company's practices, who pays for the operating expenses?
7. Do you find any loopholes of the current model that you are using to manage your Takaful funds?

B. Capitalization and Distribution

8. What factors affect your premium pricing decision?
9. How do you distribute your product?
10. How do you manage profits (do you share or distribute)?
11. To what extent are the company's investments made in Shariah compliant instruments?
12. Does your company charge certain management expenses in managing funds? If yes, is the percentage charged stated in the contract?
13. Is the profit from the investment of the Takaful fund shared between shareholders and participants? If it is shared, then what is the Shariah view on this?
14. What are the steps taken by the Shariah board to ensure all activities are in harmony with the Shariah law?

C. Risk Management

15. Who is responsible for risk management in the company
16. In your opinion, what is the major business risk faced by Takaful? Please also state why you believe so.
17. How are Takaful companies identifying, monitoring and controlling various risks in the companies?

D. General views

18. A majority of Takaful insurers currently operate in their local markets. What are the barriers for Takaful operators that make it hard for them to enter the international insurance market?
19. In your point of view, what do you believe is the future of Takaful?
20. Is Takaful the answer to mitigate the current issues/problems of the conventional insurance industry?